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IN THE

Supreme Court, U. S.
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Supreme Court of the United States

OCTOBER TERM, 197

No.

LEA ASSOCIATES, INC.,
Petitioner,

v.

THE UNITED STATES,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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Petitioner requests that a writ of certiorari be issued to review the judgment of the United States Court of Claims in this case (No. 433-66) which was entered on October 30, 1975.

* Elizabeth Kline Jordan (now deceased), originally copetitioner with Lea Associates, Inc. is not included as petitioner because the issue as to her taxes for 1960-1961 has been settled.

*Opinion Below***OPINION BELOW**

The opinion of the Court of Claims (App. A. *infra*, pp. A-1 to A-33) is reported as *Ken M. and Adeline B. Davee v. U. S.* in 195 Ct. Cl. 184; 444 F 2d 557 (1971); 1971-1 USTC 9479. The opinion, findings of fact and recommended conclusion of law of the trial judge (unreported) were adopted by the court *per curiam* with certain matter deleted.

On June 27, 1975, the court denied petitioner's motion for rehearing and reconsideration of the court's opinion of June 11, 1971, and for new trial.

*Jurisdiction***JURISDICTION**

The judgment of the Court of Claims was entered on October 30, 1975*. The jurisdiction of this court is invoked under 28 U.S.C.S. § 1255-(1).

* Appendix A 34.

*Questions Presented***QUESTIONS PRESENTED**

1. When a taxpayer pays a lump sum for a mixed group of assets, how should such payment be allocated among the assets acquired in reporting income subject to federal tax?
2. May a trial judge render an opinion on grounds not stated in any pleading or pre trial memorandum?

*Statutes, Contracts and Rules of Court Involved***STATUTES, CONTRACTS AND RULES OF COURT INVOLVED**

The pertinent provisions of the statutes, contracts and rules of court involved are set forth in Appendix B, *infra*, pp. B-1 to B- 35a.

*Statement***STATEMENT**

Concretely, the substantive question involved is the proper allocation in reporting income subject to federal tax of the amounts paid by Petitioner, Lea Associates, Inc. (hereinafter "Lea"), to Ken M. Davee (hereafter "Davee") pursuant to an agreement dated May 31, 1962.

Lea and Davee were competitors in the business of providing market research to the pharmaceutical industry. In 1962 each provided a study based on a panel of physicians, which studies were similar, surveying and serving the same market.

The panel known as NDTI was Lea's major activity and Physicians' Panel represented about one-quarter of Davee's activity.

Lea and Davee entered into two contemporaneous agreements which relate to the same transaction. In Sec. 4 of the Sales Agreement dated May 31, 1962, Davee agreed to discontinue Physicians' Panel, to be non-competitive with NDTI for five years, and in Sec. 6 to deliver materials previously generated by Physicians' Panel. By letter dated June 1, 1962 (the Letter Agreement), Davee and his wife, an able assistant to Davee, agreed to perform consulting services and not to compete for five years. Lea agreed to pay Davee \$357,500 in installments for his performance under the Sales Agreement and to pay Davee and his wife \$30,000 in installments for performance under the letter agreement.

Pursuant to these agreements Davee promptly cancelled all contracts with his clients and with physicians on the panel, put his coordinators on other work and, through his wife and other subordinates, some but not all of the material generated by Physicians' Panel was transferred to Lea over a period of about five months.

Statement

Promptly following cancellation of contracts by Davee, Lea solicited the former subscribers to Physicians' Panel to become subscribers to NDTI.

Pursuant to the terms of the two agreements, Lea completed payments to Davee over a period of five years.

The net effect of the transaction from the point of view of the pharmaceutical industry was that Physicians' Panel was discontinued and only NDTI remained for sale.

Lea then deducted the payments made to Davee pursuant to the Sale Agreement dated May 31, 1962, in computing taxable income for the years 1962-1967.

The District Director has disallowed Lea's deduction of the \$357,500 paid to Davee stating merely:

"... to treat as a non-deductible capital expenditure that portion of the cost of a business ..." (Report of Corporation Income Tax Audit Changes dated 9/21/65).

For an understanding of how the foregoing relatively simple state of facts and the clear rule of law governing the same became obscured in the Court of Claims, it is necessary to include in this statement an account of the procedures followed in this case.

On December 30, 1966, Lea filed the petition in the Court of Claims commencing this proceeding (No. 433-66) on an issue unrelated to the matter here in controversy, and on April 18, 1968, Lea amended its petition to include a claim on the same unrelated issue for its taxable year 1962. Such issue has since been settled and stipulation to that effect filed in the Court of Claims October 21, 1975.

On June 5, 1968, Respondent, United States, filed its answer to Lea's amended petition and counterclaimed for \$40,690.02 for Lea's taxable year 1962, such counterclaim being for a deficiency computed by disallowance of the payment made by Lea to Davee during 1962.

Statement

On July 5, 1966, Davee had filed a petition in the Court of Claims (No. 242-66) raising the converse of the issue in this case, namely, the proper tax accounting for the amounts received from Lea pursuant to the agreement of May 31, 1962.

The *Davee* case was tried at Chicago April 25, 1968. Witnesses called were the chief executive officer for Lea and Davee. Counsel for Lea was present but did not participate in the trial which was conducted by counsel for Davee and counsel for the United States.

At the trial of Lea's case held at Philadelphia August 1, 1968, it was stipulated by counsel that the record and exhibits in the case of *Ken and Adeline B. Davee vs. The U. S.* (No. 242-66), but not the pre-trial memorandum therein, might be used as testimony in this proceeding.

At such trial Lea addressed itself directly to the respondent's determination that the payment to Davee was a "non-deductible capital expenditure" for the "cost of a business" and took testimony from two witnesses, one expert in data processing and one expert in taxes and in corporate acquisitions. Their testimony was (1) that Lea acquired nothing of value from Davee other than his discontinuance as a competitor, (2) that there was no purchase of a going business with verification by audit, etc., and (3) that at least on their federal tax return Ken and Adeline Davee did not account for the proceeds from their Physicians' Panel as a separate business. There was no evidence to the contrary at this trial nor at the earlier trial of the *Davee* case (No. 242-66) at Chicago.

The Court of Claims decided that Respondent United States was entitled to recover on its counterclaim against Lea and it is this decision which is here sought to be reviewed, Lea's case in chief, which was the subject of its original petition to the Court of Claims having been settled.

Reasons for Granting the Writ

REASONS FOR GRANTING THE WRIT

The decision of the Court of Claims disallowing Lea's deduction of amounts paid to Davee conflicts with decisions of the Circuit Courts and of the Supreme Court of the United States.

The determination by the Court of Claims against Lea was made on grounds which had not been stated in pleading filed in this case and was based on the testimony of witnesses who were not subject to either examination or cross-examination by Lea.

I. Law

The underlying propositions of law governing this matter are four in number, to wit:

1. Under a statute imposing differing rates of tax upon varying transactions, receipts or expenditures must be allocated in accordance with the assets transferred or the services performed. *Aaron F. Williams v. McGowan*, 152 Fed. 2d 570, CCA 2nd, 1945, 1946-1 USTC ¶ 9120; *Watson v. Commissioner*, 345 U.S. 544, 73 S. Ct. 848, 1953-1 USTC ¶ 9391; *Rev Rul 55-79* (1955-1 CB 370).

2. In allocating receipts or payments pursuant to a particular contract, the value of the items transferred, the agreement of the parties, and all of the surrounding circumstances will be considered. *Com. v. Danielson*, 378 Fed. 2d 771, 1967-1 USTC ¶ 9423, Cert. Denied SCUS Oct. 9, 1967; *Rev Rul 55-79, supra*.

3. Payments made and received for an agreement not to compete must be reported as expense and ordinary income, and payment made and received for good will is a purchase and sale of a capital asset. (*Covenants Not to Compete; 18th Annual Institute on Federal Taxation* 861).

Reasons for Granting the Writ

4. The burden of proof is on the taxpayer and the Trial Commissioner has the duty to weigh the evidence submitted in discharge of that burden. *Missouri Pacific Railroad Company v. The United States*, 338 Fed. 2d 668, 1964-2 USTC ¶ 9839, 168 Ct. Cls. 86; *Com. v. Danielson, supra*.

II. Conflict with Circuit Court of Appeals and with the Supreme Court.

1. Conflict with *Williams v. McGowan* and *Ernest A. Watson*, both *supra*.

The Opinion of the Court of Claims states, "The sale of a going business gives rise to a capital gain or loss since it is the sale of a capital asset" (p. 9).

The foregoing is flatly contrary to the rule of *Williams v. McGowan, supra*, by L. Hand J. which has governed this issue since 1946 and with this Court's decision in *Ernest A. Watson v. Com., supra*.

The rule of those cases is restated in Rev Rul 55-79 *supra* in part, as follows:

"For Federal income tax purposes, the sale of a going business operated as a sole proprietorship does not constitute the sale of a single asset. Such a sale constitutes a sale of the individual asset comprising the business. For the purpose of determining whether the gain on the sale of a particular asset is to be included in gross income as an item of ordinary income or whether it is to be treated as gain from the sale of a capital asset, all of the individual assets sold must first be classified as to (1) capital assets as defined in section 117(a) of the Internal Revenue Code of 1939, (2) property used in trade or business as defined in section 117(j) of the Code, and (3) other property not coming within the provisions of section

Reasons for Granting the Writ

117(a) or section 117(j) of the Code . . . The selling price must be allocated among all the assets sold according to the respective relative values thereof, for example, according to the ratio of the value of each individual asset to the sum total of the values of all the assets sold. Separate computations must be made of the gain or loss with respect to each asset sold, and the gain or loss in each case must be treated in accordance with the classification of such asset, as described above. See *Aaron F. Williams v. McGowan*, 152 Fed (2) 570; *Ernest A. Watson v. Commissioner*, 345 U.S. 544, Ct. D. 1760, C. B. 1953-1, 179."

Because of this fundamental misconception of the law, that the assets purchased from Davee were necessarily capital assets (other than the \$30,000 paid pursuant to the Letter Agreement), the real issue in this case remains undetermined, namely, what did Lea get by paying Davee \$357,500? Lea alone in this proceeding has provided any evidence as to how the \$357,500 should be allocated to the assets acquired. There is no evidence to the contrary.

2. Conflict with *Com. v. Danielson, supra*.

The opinion below adopts Respondent's position that "the Court should not then go behind the agreement at the insistence of either party unless there is shown fraud, duress, or undue influence such as would be necessary to alter the terms of the contract itself. *Commissioner v. Danielson*, 378 F 2d 771 (C.A. 3d, 1967)." (p. 10)

The foregoing is a mixed error of law and fact. As to the error of fact, Lea has not challenged the Sale Contract pursuant to which it paid \$357,500 to Davee. Lea affirms that contract and has submitted the only evidence in this proceeding as to what it acquired for that payment and as to how that payment should be allocated.

Reasons for Granting the Writ

The Commissioner of Internal Revenue challenged Lea's interpretation of the contract by his determination that payments pursuant thereto should be treated as "non deductible capital expenditure."

A correct statement of the law would be as follows:

When the allocation of amounts paid or received for a group of assets is challenged by the Commissioner of Internal Revenue, then the Court has the duty to determine the correct allocation under all the facts and circumstances.

The Respondent has adopted the inconsistent position of challenging Lea's interpretation of the contract, offering no evidence in support of his position and then citing an erroneous proposition of law that the Court may not examine the evidence.

The opinion below misapplies the rule of the *Danielson* case, *supra*, wherein the Third Circuit Court held:

"Where the Commissioner attacks the formal agreement the Court involved is required to examine the 'substance' and not merely the 'form' of the transaction . . ."

The rule of law is clear that the Commissioner of Internal Revenue, having challenged allocation by the taxpayer, the trier of fact must weigh all the evidence, including any allocation by agreement in determining the issue and this is the rule in the Tax Court and in every Circuit wherein this question has been considered.

III. Departure from accepted judicial proceedings.

The sole statement by Respondent with respect to its counterclaim against Lea is found in a revenue agent's report, to wit:

Reasons for Granting the Writ

". . . to treat as non-deductible capital expenditure that portion of the cost of a business . . ." (Report of Corporation Income Tax Audit Changes dated 9/21/65.)

Faced with a determination that its payments to Davee were capital in nature, Lea went to trial prepared to face that issue and introduced testimony of two experts as to the value of what was acquired from Davee. There was no testimony to the contrary. It was stipulated by counsel that the testimony taken at the trial of the Davee case (but not the pre trial memorandum) could be used as testimony in the trial of Lea's case.

The court below then based its determination against Lea on a finding that Lea had entered into a binding contract with Davee making allocation of the payments between them. The fact that this finding is contrary to the testimony in the Davee case is here beside the point which is that a determination against Lea was made on grounds never adumbrated by any pleading or pre trial memorandum and based on testimony of witnesses which Lea was never allowed either to examine or to cross examine.

It is well established by the trial courts in matters involving federal income tax that the burden on the taxpayer is limited to the issues present at the time of the trial. Citation of one case should suffice for this self-evident proposition.

"A second proposition, the failure of the taxpayer to show the amount of the loss, was raised and argued by the government for the first time in its post-trial brief. The burden of the taxpayer, as cited under this proposition, is, however, limited to the issues present at the time of trial. We find no obligation to answer arguments subsequently raised, and to adopt this

Reasons for Granting the Writ

course would, in our judgment, render pleadings useless and impose an intolerable burden upon the plaintiff. The taxpayer did put in evidence the value of the machinery at the time it was scrapped and that was the only evidence introduced upon the subject. At this question was not hitherto raised and the taxpayer had otherwise sustained her burden, we are not at this late date required, nor do we feel inclined, to examine the matter further." (*Thomas A. Walsh, Jr. v. U.S. Dist. Court Neb.* 163 F. Supp 421, 425, 1958-2 USTC ¶ 9713.)

In this case Lea directed its testimony to the issue raised by the Respondent and showed the value of the assets acquired and the proper allocation thereto of the purchase price. Respondent and the court below have responded with a determination that Lea had entered into a binding contract allocating purchase price, a proposition of which Lea was given no warning by the pleadings. The Court of Claims should have, as did the District Court of Nebraska, refused to consider an argument which was raised for the first time on brief.

The trial judge departed from accepted judicial proceedings by his failure to employ any of the pre-trial procedures as outlined in Rules 111-113 of the Court of Claims (Appendix B)*(46a)*.

Conclusion

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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January 26, 1976